

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:NR:DAL:1:POSTF  
TALudeke

date: August 12, 2002

to: Frank McKinney  
Technical Adviser

from: Associate Area Counsel Industry Programs  
(Natural Resources)

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subject: [REDACTED]  
Section 631 (b) economic interest issue

This memo is in response to your request for advice of July 16, 2002. It should not be cited as precedent.

You've asked for advice concerning whether [REDACTED] had an economic interest in the timber sold under certain lump-sum contracts. For the reasons set forth below, we do believe that it maintained an economic interest in the timber and that the timber sales are subject to § 631(b) treatment.

STATEMENT OF FACTS

During the years at issue, [REDACTED] entered into several transactions to sell timber. These transactions relied on a standard timber deed. The deed provided that the purchaser had 18 months from the day the contract was signed to cut and remove the timber sold under the contract. This period could be extended by six months. Upon expiration of the time in the contract (including extension), any timber left on the property reverted to [REDACTED]

If timber remained on the property at the end of the contract, [REDACTED] was required to have the property evaluated to determine the quantity of timber remaining. The purchaser was then paid for the value of the uncut trees, less [REDACTED] percent of that amount. This represented liquidated damages for failure to cut all trees. If the timber was destroyed (except by pine beetles), the seller would pay a similar amount to the purchaser - the value of uncut trees [REDACTED] percent as liquidated damages.

Compensation under the contracts was determined based upon how many trees were in the cutting area and the type of tree that would be removed. The compensation was paid at the beginning of the contract. [REDACTED] claims that they retained an economic interest in the timber since they were obligated to repay the purchaser for uncut timber at the expiration of the contract.

## ANALYSIS

Section 631(b) provides capital gains treatment for timber that is sold under a contract in which the seller retains an economic interest in the timber. There are four requirements a timber transaction must meet to qualify under § 631(b):

- (1) the taxpayer must be the owner of the timber;
- (2) the taxpayer must have held the timber for at least one year;
- (3) the taxpayer must dispose of the timber under a contract; and
- (4) the taxpayer must retain an economic interest in the timber.

Burnett, 610 T.M., *Timber Transactions*, at A-13 (1994).

The only requirement at issue here is whether [REDACTED] retained an economic interest in the timber. Economic interest is defined in Treas. Reg. § 1.611-1(b). In order to possess an economic interest in timber a taxpayer must look to the "severance of the timber," Treas. Reg. § 1.611-1(b)(1), for a return on its investment:

It is essential that the consideration for the transaction, whether payable in cash or in-kind, be contingent upon the severance of the timber, and payable to the owner solely out of the proceeds from the natural resource itself.

*Dyal v. United States*, 342 F.2d 248, 252 (5<sup>th</sup> Cir. 1965) (holding that a contract that required annual payments which were not tied to the amount of timber harvested did not qualify under § 631(b). See, *Boeing v. United States*, 98 F. Supp. 581 (Ct. Cl. 1951) (holding that a contract that required the taxpayer to pay for all merchantable timber on a tract regardless of whether it was cut or not did not qualify under § 631(b)).

Other cases have also addressed situations where annual payments were not tied to the amount of timber removed. In *Crosby v. United States*, 414 F.2d 822 (5<sup>th</sup> Cir. 1969) the court addressed a contract that contained a timber backlog provision. The contract required the purchaser to make payments equal to the average growth of timber on a certain tract. If that amount of timber was not cut, it went into a timber backlog account that could be cut without further payment. At the expiration of the contract, all timber not cut remained the property of Crosby and it retained all payments, even if there was a timber backlog. Examining the situation, the court noted that "is possible for the taxpayers to receive their payments without a single tree ever been cut." *Id.* at 825. As a result, the taxpayer did not retain an economic interest in the timber and § 631(b) did not apply.

In a later case, the Eleventh Circuit addressed a similar situation. *Plant v. United States*, 682 F.2d 914 (11<sup>th</sup> Cir. 1982). There the court addressed a contract that required the purchaser to pay a base price per cord and to pay for at least 2000 cords per year regardless of the actual harvest. If the purchaser cut more than 2000 cords in a year, compensation for the excess cords was payable at the end of the year. If less than the minimum was cut, a timber backlog clause allowed the purchaser to harvest that amount at any time prior to the expiration of the contract. At the expiration of the contract, Plant could retain as liquidated damages payments for any

amounts not actually harvested. Citing *Crosby*, the court noted that the contract "permit[ted] the landowners to retain the consideration previously paid thereunder at the end of the contract term without obligating them to make a refund for the uncut timber." *Id.* at 917. As in *Crosby*, therefore, Plant did not retain an economic interest in the timber and § 631(b) did not apply.

The Tax Court has followed *Crosby* and *Plant*. *Godbold v. Commissioner*, 82 T. C. 73 (1984). In that case, the court addressed a contract similar to the one at issue in *Plant*. Because the payment under the contract was not tied directly to the amount of timber cut, the court held that the contract did not qualify under § 631(b).

The Service has addressed similar situations. In Rev. Rul. 61-56, 1961-1 C.B. 243, the Service held that an amount received upon the default on a cash performance bond posted as security for a timber-cutting contract did not qualify as amount realized under § 631(b). In a ruling similar to the facts here, the Service held that a penalty amount in a timber-cutting contract did not qualify under § 631(b). Rev. Rul. 78-104, 1978-1 C.B. 194. In that ruling, the taxpayer entered into an agreement to sell certain marked timber on a tract. The taxpayer retained title to all the timber until it was severed and was responsible for any loss or damage to the marked timber prior to sale. If all of the marked timber was not cut, the purchaser was required to pay only for the timber that was cut. The contract contained a clause, however, that required the purchaser to pay a penalty of one-third the bid rate multiplied by the amount of marked timber that was not cut. Because the amount received by the taxpayer was dependent solely upon the quantity of timber cut, the Service held that the taxpayer had retained an economic interest in the timber. The penalty amount, however, was not attributable to the disposal of the timber, but was a form of damages. It was treated as ordinary income.

In this case, the amount of timber actually cut appears to relate directly to the proceeds received by [REDACTED]. In other words, [REDACTED] must look to the "severance of the timber," Treas. Reg. § 1.611-1(b)(1), for a return on its investment. Under the contract, [REDACTED] will be paid for all timber harvested. Any unharvested timber remains the property of [REDACTED]. Moreover, the purchaser is not obligated to pay for the trees that are not actually cut. Rather, as in Rev. Rul. 78-104, there is a penalty provision that provides compensation to [REDACTED] for the uncut trees. In addition, [REDACTED] retains an interest in the trees that are damaged by fire or other destruction. Unlike in *Crosby* or *Plant*, the possibility does not exist that the purchaser will pay for uncut trees (except to the extent of the damages clause). [REDACTED] has retained an economic interest in the trees and the contract does qualify under § 631(b).<sup>1</sup>

Though the contract does meet the requirements of § 631(b), the penalty provision does not. As with the penalty payment at issue in Rev. Rul. 78-104, the penalty amount - if applicable - does not qualify under § 631(b).

## CONCLUSION

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<sup>1</sup>It's unclear from the contract how the volume of trees on a tract was calculated. It's also unclear whether there's an adjustment process in the contract to correct for any deviations between the initial estimate of trees and the trees actually harvested. We should obtain a copy of the contract in order to further explore this issue.

The [REDACTED] contract does qualify under § 631(b). The liquidated damages payments, however, do not qualify. If you have any questions please contact Todd Ludeke at (972) 308-7926.

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By: \_\_\_\_\_  
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